M. EMPLOYMENT TAXES

by
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1. Introduction

In recent months, Congress has again turned its attention to the employment tax provisions of the Internal Revenue Code. The House Government Operations Committee has twice held hearings on classification of workers as independent contractors or employees, and has received a General Accounting Office Report on that issue. See Tax Administration Problems Involving Independent Contractors, H.R. Rep. No. 101-979, 101st Cong., 2d Sess. (Nov. 9, 1990); General Accounting Office, Tax Administration: Information Returns Can Be Used to Identify Employers Who Misclassify Workers, GAO/GGD-89-107 (1989). It was estimated at these hearings that as much as $1.5 billion in income, social security, and unemployment tax revenue is lost annually due to employer non-compliance with the employment tax provisions.

The House Report recommends that the "prior audit" safe haven (contained in Section 530(a)(2)(B) of the Revenue Act of 1978, discussed below) be eliminated. Legislative action, if forthcoming, will not resolve all difficulties in employment tax compliance, however.

Employment tax revenues and penalties collected from exempt organizations increased almost 500 percent in the past three fiscal years - from total collections of $16,639 ($314 per return) in 1988 to $5,627,059 ($1,484 per return) in 1990. This evidences the effect of the Service's commitment to an effective employment tax examination program. This article is intended to respond to needs perceived, by EO examination agents, Service management, and others, for additional technical training on employment tax issues.

The federal employment tax system consists, for most exempt organizations, of three taxes: the Federal Insurance Contributions Act (FICA) tax, the Federal Unemployment Tax Act (FUTA) tax, and the Collection of Income Tax at Source on Wages Act tax (referred to as federal income tax withholding, or ITW). IRC 3121(a) and 3306(b), which reversed the decision in Rowan Companies, Inc. v. United States, 452 U.S. 247 (1981) (definition of wages for FICA, FUTA, and ITW purposes must be interpreted consistently), make clear that each act's requirements must be considered separately.

While requirements sometimes differ in specific details, however, the three acts share certain common concepts. Each requires--

(1) Remuneration for employment ("wages");

(2) A certain relationship between payor and payee (usually employer/employee); and

(3) A non-exempt payor, payee, and type of service.

Part II of this article briefly describes specific requirements of FICA, FUTA, and ITW. Parts III, IV, and V address the three common concepts: taxable payments (Part III), employer/employee classification (Part IV); and exemptions (Part V). Procedures for deposit, payment, and collection of taxes, and penalties for nonpayment, are by and large beyond the scope of this article. (Note that the deposit requirements were recently revised, effective for deposit periods beginning after March 31, 1991. See T.D. 8341, 1991-16 C.B. 4 (Apr. 22, 1991)).

2. Employment Taxes - Specific Requirements

A. FICA

The FICA taxes include a tax for old age, survivors, and disability insurance ("Social Security" tax), and a tax for hospital insurance ("Medicare" tax). IRC 3101 imposes these taxes on employees (the "employee's tax"), and IRC 3111 on employers (the "employer's tax"). An "employer" must withhold the employee tax from "wages" pursuant to IRC 3102. Both the employee, Reg. 31.3101-2(c), and employer, Reg. 31.3111-2(c), taxes are computed by applying the applicable rate to each payment of wages. For 1991, employer and employee must each pay a tax of 6.2% (Social Security) and 1.45% (Medicare) of the applicable wage base. Beginning in 1991, the wage base for each tax is different: this year, it is $ 53,400 for Social Security and $125,000 for Medicare.

B. FUTA

IRC 3301 imposes the FUTA tax on "employers" who either (IRC 3306(a)(1)) pay "wages" during a calendar quarter in the current or preceding calendar year, of $1,500 or more; or employ at least one individual at any time in each of any 20 calendar weeks in the current or preceding calendar year. The tax is computed by

applying the applicable rate to each wage payment. Reg. 31.3301-3(b). For 1991, the tax is 6.2% of the first $7,000 in remuneration during a calendar year.

Under IRC 3302, the employer may receive a credit of up to 5.4% of taxable remuneration (90% of the tax) against the tax for contributions to state unemployment funds approved by the Secretary of Labor pursuant to IRC 3304 and 3303. Voluntary contributions to state unemployment funds, not required by state law, may not be claimed as a credit. Rev. Rul. 72-185, 1972-1 C.B. 327. To receive the credit, the employer must submit a certificate from the state to which taxes were paid, and certify that no state payment for which a credit is claimed was deducted from employees' remuneration. Reg. 31.3302(a)-3.

An employer is liable for FUTA taxes even though it is exempt from state taxes. Rev. Rul. 75-87, 1975-1 C.B. 325.

As discussed in Part V, below, there is no liability for the FUTA tax with regard to services performed in the employ of a religious, charitable, educational, or other organization described in IRC 501(c)(3). See IRC 3306(c)(8).

C. ITW

IRC 3402(a) requires an employer who pays wages to deduct and withhold a withholding tax from each wage payment. IRC 3403 emphasizes that the withholding tax is the employer's liability. If an employer fails to withhold tax, but the employee thereafter pays the related income tax, the ITW tax may not be collected from the employer. Reg. 31.3402(d)-1. This does not relieve the employer from liability for penalties or additions to tax, however. Id.

Withholding exemptions: The amount withheld depends on the number of withholding exemptions or allowances claimed by the employee. Permitted exemptions are specified in IRC 3402(f)(1); see also Reg. 31.3402(f)(1)-(1)(b)-(e). To claim an exemption, the employee must, on or before the date employment commences, furnish the employer a signed withholding exemption certificate (Form W-4) indicating the number of exemptions claimed. IRC 3402(f)(2)(A); Reg. 31.3402(f)(2)-1(a). The employee must file a new certificate if the number of exemptions he/she is entitled to claim during the calendar year decreases, and may file a new certificate if the number increases. IRC 3402(f)(2)(B); Reg. 31.3402(f)(2)-1(b). The employee must also file a new certificate for changes affecting a new calendar year. IRC 3402(f)(2)(C); Reg. 31.3402(f)(2)-1(c). The employer may not reimburse an employee for taxes withheld before the employee files a new certificate

showing an increase in exemptions. Rev. Rul. 82-84, 1982-1 C.B. 208. It must, however, reimburse the employee for taxes withheld after the effective date of a new exemption certificate. Id. (applying IRC 6413(a) and Reg. 31.6413(a)-1).

If no exemption certificate is received, the number of exemptions is deemed to be zero. IRC 3401(e); Reg. 31.3401(e)-1(a). The number is also deemed to be zero if the employee files an invalid certificate, or indicates the information in the certificate is false and fails to file an amended certificate at the employer's request. See Reg. 31.3402(f)(2)-1(e). Although an employer is not required to ascertain the validity of claimed exemptions, Reg. 31.3401(e)-1(b), it must, if it knows information on an exemption certificate is invalid, request an amended certificate and deem the number of exemptions to be zero if one is not furnished, Rev. Rul. 80-68, 1980-1 C.B. 225.

The employer must submit copies of certain withholding certificates to the Service with its quarterly withholding tax return if the employee is employed on the last day of the reporting period. Certificates that must be submitted are those on which the employee claims more than 10 exemptions, or claims exemption from withholding and the employer expects wages to exceed $200 per week. See Reg. 31.3402(f)(2)-1(g)(1)-(2). If the Service determines information on a certificate is false, it will notify the employer of the correct number of exemptions; the employer must then use that number in determining the amount of withholding. Reg. 31.3402(f)(2)-1(g)(5).

Withholding methods: The Code and Regulations describe seven ways the amount of withholding may be determined. An employer may generally use any permissible method for each employee, and for each payment of wages. Reg. 31.3402(a)-1(a). In addition, an employer may use any method that produces substantially the same tax required to be withheld using the percentage or wage bracket method. IRC 3402(h)(4). An amount of tax is "substantially" the same if the deviation from the amount required to be withheld using the annualized wage method is not greater than specified in Reg. 31.3402(h)(4)-1(a).

Withholding is based, in part, on the employee's "payroll period." Reg. 31.3402(b)-1(b) says an employee can have only one payroll period for wages paid by any one employer. Relying on this regulation, the Service held that a school which ordinarily paid teachers semi-monthly, but which in June made a single payment of six semi-monthly wage installments, should compute withholding as though it were making six separate semi-monthly payments. See Rev. Rul. 65-231, 1965-2 C.B. 398.

Permitted withholding methods are as follows:

(1) ***Percentage method:*** The percentage method of withholding is described in Circular E (Employer's Tax Guide). See Reg. 31.3402(b)-2. The amount withheld is based on a table which takes into account the payroll period (weekly, bi-weekly, etc.), the employee's marital status, the amount of the wage payment, and withholding allowances claimed. The amount withheld may be computed based on wages to the nearest whole dollar. IRC 3402(b)(4). Publication 493, Alternative Tax Withholding Methods and Tables, provides alternative tables for percentage withholding, suited for automated payroll systems, as well as combined income, social security, and medicare tax withholding tables.

(2) ***Wage bracket method:*** The wage bracket method is also described in Circular E. See Reg. 31.3402(c)-1(a)(1). As under the percentage method, withholding is based on a table which takes into account payroll period, marital status, wage payment amount, and withholding allowances. If the wage payment exceeds the highest wage bracket, the amount withheld may be computed based on wages to the nearest whole dollar. IRC 3402(c)(5); Reg. 31.3402(c)-1(e). If more than 10 withholding exemptions are claimed, an additional computation, described in Circular E, must be performed. The regulations provide additional rules for determining the applicable payroll period in various circumstances. See Reg. 31.3402(c)-1(b) (established payroll periods, other than daily or miscellaneous, covered by tables); 31.3402(c)-1(c) (periods to which tables for daily or miscellaneous period apply); and 31.3402(c)-1(d) (period of elapsed time less than week). Publication 493 provides wage bracket percentage method withholding tables, suited for automated payroll systems.

(3) ***Annualized wages method:*** The annualized wage method, permitted by IRC 3402(h)(5), entails three steps. First, multiply wages for the payroll period by the number of payroll periods in the calendar year. Second, determine the amount required to be withheld under the percentage method on the annualized amount. Finally, divide the hypothetical annualized withholding by the number of payroll periods during the year to determine the amount required to be withheld. See Reg. 31.3402(h)(2)-1.

(4) ***Average estimated wages method:*** An employer may determine the amount of withholding based on an estimate of wages which will be paid to an employee in any quarter. See IRC 3402(h)(1); Reg. 31.3402(h)(1)-1. The amount withheld is determined using other methods, as applied to estimated wages. At the end of the quarter, the employer must withhold any additional amount needed to adjust withholding to the amount required on wages actually paid. This method is particularly suited to tips subject to withholding under IRC 3402(k).

(5) ***Cumulative wages method:*** An employee may request, in writing, to have wages withheld under the cumulative wages method. See IRC 3402(h)(3); Reg. 31.3402(h)(3)-1. The method is available only if the employee has been paid since the beginning of the current calendar year according to the same payroll

period. Reg. 31.3402(h)(3)-1(a). The procedure, as further described in Rev. Proc. 78-8, 1978-1 C.B. 562, is as follows:

(a) Add wages for current payroll period to total wages paid during calendar year.

(b) Divide that amount (cumulative wages) by number of payroll periods to date in year.

(c) Determine tax to be withheld, using percentage method, on cumulative wages.

(d) Subtract amount withheld to date during year from hypothetical withholding on cumulative wages, and withhold that amount.

(6) ***Part-year employment method:*** An employee who works less than 245 days (for any employer) during a calendar year, see Reg. 31.3402(h)(4)-1(c)(4), may request, in writing, to have withholding based on the part-year employment method. The employee's request must contain the information specified in Reg. 31.3402(h)(4)-1(c)(5). The procedure for this method is as follows:

(a) Add wages for the current payroll period to total wages paid during current "term of continuous employment" (defined in Reg. 31.3402(h)(4)-1(c)(3)).

(b) Add number of payroll periods in current term of continuous employment to number of payroll periods between employee's last employment and current employment. (See Reg. 31.3402(h)(4)-1(c)(2) for how to determine latter number.)

(c) Divide total wages determined in Step (a) by number of payroll periods determined in Step (b).

(d) Determine amount to be withheld on amount determined in Step (c), using other withholding methods (e.g., percentage or wage bracket).

(e) Multiply number of payroll periods (Step (b)) by hypothetical withholding amount (Step (d)).

(f) The amount to be withheld on the current payment of wages is determined by subtracting the amount determined in Step (e) from the total amount withheld during the current term of employment.

(7) ***Supplemental wage method:*** The employer may withhold at a flat 20% rate on the "supplemental" portion of any wage payment, if properly identified. See generally Rev. Rul. 82-200, 1982-2 C.B. 239, revoking Rev. Rul. 67-88, 1967-1

C.B. 289. "Supplemental wages" to which this method applies include bonuses, commissions, and overtime pay, Reg. 31.3402(g)-1(a), but generally not vacation pay, see Reg. 31.3402(g)-1(c). Alternatively, the employer may aggregate the payment with regular wages paid for the same or preceding period, and withhold on the total amount using other withholding methods. An alternative method is provided where a supplemental payment is for a period covering two or more consecutive payroll periods of not less than one week and the employee's withholding exemptions exceed wages for the regular payroll periods. See Reg. 31.3402(g)-1(b)(2).

Voluntary withholding: Regulations under IRC 3402(p) provide that an employee may enter into an agreement with his/her employer for withholding on amounts, qualifying as gross income under IRC 61, that do not constitute wages, or from any other type of payment. A voluntary withholding agreement must cover all such amounts paid by the employer, Reg. 31.3402(p)-1(a), and is effective for the period agreed on by employer and employee, Reg. 31.3402(p)-1(b)(2). Payments subject to voluntary withholding are treated as wages for the period the agreement is in effect.

Withholding on gambling winnings: A payor of gambling winnings must withhold an amount equal to 20% of the payment, if the payment is from one of three sources:

(1) ***Lottery conducted by state agency acting under authority of state law***, if proceeds from wager exceed $5,000. IRC 3402(q)(3)(B).

(2) ***Sweepstakes, wagering pool, or lottery (other than state lottery)***, if proceeds from wager exceed $1,000. IRC 3402(q)(3)(C)(i).

(3) ***Wagering transaction in parimutuel pool on horse races, dog races, or jai alai***, if proceeds from wager exceed $1,000 and are at least 300 times the amount wagered. IRC 3402(q)(3)(A), 3402(q)(3)(C)(ii). Reg. 31.3402(q)-1(c)(3) says this provision covers any wagering transaction other than one in a lottery, sweepstakes, or wagering pool.

"Proceeds" of a wager are determined by reducing the amount of the payment by the amount of the wager. IRC 3402(q)(4)(A); Reg. 31.3402(q)-1(c)(ii); see Rev. Rul. 85-46, 1985-1 C.B. 334 (withholding on lottery proceeds required by exempt organization). Non-monetary proceeds are taken into account at fair market value. IRC 3402(q)(4)(B); Reg. 31.3402(q)-1(c)(1)(iii). Periodic payments are aggregated to determine if proceeds exceed the threshold and are subject to withholding. Reg. 31.3402(q)-1(c)(1)(iv). Amounts paid with respect to identical wagers are also aggregated. See Reg. 31.3402(q)-1(c)(ii).

The following are excepted from gambling withholding requirements:

(1) ***Payment from a slot machine, or bingo or keno game***. IRC 3402(q)(5). Although withholding may not be required for bingo proceeds, Form 1099 may be. See Reg. 7.6041-1.

(2) ***Payment to nonresident alien individual or foreign corporation***, if subject to withholding under IRC 1441(a) or 1442(a). IRC 3402(q)(2); Reg. 31.3402(q)-1(c)(4).

Gambling winnings are treated as payments by employer to employee, for purposes of IRC 3403 and 3404 and provisions of subtitle F (except IRC 7205). IRC 3402(q)(7); Reg. 31.3402(q)(5). Also, the recipient of winnings subject to withholding must furnish the payor a statement (generally on Form W-2G) of his/her name, address, and TIN, and the same information for any other person entitled to part of the payment (or a statement that no person is so entitled). IRC 3402(q)(6); Reg. 31.3402(q)-1(e). The payor pays the tax, using Form W-2G, transmitted with Form W-3G. Reg. 31.3402(q)-1(f).

Backup withholding: Under IRC 3406, the payor of a "reportable payment" is required to withhold 20% of the amount of the payment, unless (1) the payee is exempt from withholding; (2) the payee satisfies the requirements of IRC 3406(a)(1) (by furnishing taxpayer identification number to payor, and/or meeting certain other requirements); or (3) the amount is subject to withholding under another Code provision.

Exempt payees include exempt organizations, corporations, financial institutions, domestic and foreign governmental entities, and certain international organizations. See IRC 3406(g)(1); Reg. 35a.9999-1T, Q&A-29; Reg. 31.3452(c)-1(b)-(p). If the payee certifies it is awaiting assignment of a TIN, it is not subject to backup withholding for 60 days. IRC 3406(g)(3); Reg. 35a.9999-2T, Q&A-18. Exempt organizations may receive a refund of amounts erroneously withheld, under procedures in Ann. 88-78, 1988-19 I.R.B. 47.

Backup withholding has little relevance to exempt organizations as payors, given the nature of most organizations' activities. Examiners should be alert to the possibility of backup withholding liability, however, with organizations which make "reportable payments" such as interest, dividends, and services for which IRC 6041 requires Form 1099-Misc to be filed.

3. Taxable Payments

In general: Aside from gambling and backup withholding requirements, the employment tax provisions are concerned principally with payments for services rendered. For FICA purposes, the relevant term is "wages," defined in IRC 3121(a) as "all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash ...," with certain exceptions. The regulations reiterate that all "compensation for employment" is taxable, Reg. 31.3121(a)-1(b), and that the basis upon which payment is made (e.g., piecework or percentage of profits, periodic or otherwise) is immaterial, Reg. 31.3121(a)-1(d), as is the medium (cash or non-cash), Reg. 31.3121(a)-1(e). Fringe benefits are specifically noted as being taxable wages. Reg. 31.3121(a)-1T, Q&A-1. The FUTA definition is identical. See IRC 3306(b); Reg. 31.3306(b)-1(b), (d), (e); Reg. 31.3306(b)-1T, Q&A-1. The ITW definition differs only slightly, specifically excluding fees paid public officials, and indicating that payments which are "remuneration for services performed by an employee for his employer" (rather than "remuneration for employment" are subject to tax. See IRC 3401(a); Reg. 31.3401-1(a)(2)-(4); Reg. 31.3401(a)-2T, Q&A-1. That services for which remuneration or compensation is paid are illegal is irrelevant. Rev. Rul. 60-77, 1960-1 C.B. 386.

The Compensation topic in the 1990 CPE text discusses general principles and specific exceptions, a discussion which will not be repeated here. While income tax principles which were the principal focus of the previous article do not apply directly in the employment tax context, many exclusions from "wages" are tied, directly or indirectly, to related income tax exclusions. The income tax treatment of most fringe benefits, for example, is tied to income tax treatment of those benefits, by reference to Code provisions providing income tax exclusions for individuals.

Precedents on the treatment of particular types of payments are described in Appendix A. The table beginning at page 15 of the 1991 Circular E summarizes available exclusions.

If an employee's remuneration for services performed for an employer during half or more of a payroll period of not more than 31 consecutive dates constitutes "wages" (or "included service," for FICA and FUTA purposes), all remuneration the employer pays the employee during that period is subject to tax, and vice versa. IRC 3121(c), Reg. 31.3121(c)-1 (FICA); IRC 3306(d), Reg. 31.330-6(d)-1 (FUTA); IRC 3402(e), Reg. 31.3402(e)-1 (ITW).

Training/rehabilitation program payments: Whether payments to individuals in connection with training and rehabilitation programs are taxable is an issue not readily categorized as one of "taxable" versus "non-taxable" wages or "employer-employee" relationship. Several rulings address the treatment of such payments, reaching different results and sometimes using different approaches.

The general rule is easily stated: Where payments are remuneration for services performed by an employee for an employer, they are taxable. Thus, Rev. Rul. 60-149, 1960-1 C.B. 393, held that a hospital patient placed, as "work therapy," in a part-time job at a private residence, who performed services at the direction of the residence owner, was the owner's "employee" for employment tax purposes. (The service was within the "domestic service" exemption, however, and the remuneration was consequently not taxable.) Similarly, Rev. Rul. 65-139, 1965-1 C.B. 31, clarified, Rev. Rul. 66-240, 1966-2 C.B. 19, held that payments for services performed in work training programs under Title I-B of the Economic Opportunity Act of 1964 were taxable to the payor/recipient of services. See also Rev. Rul. 75-246, 1965-1 C.B. 24 (services performed in on-the-job training program under Comprehensive Employment and Training Act; note that services performed under the Job Corps Training Act are similar to those described in Rev. Rul. 75-246); Rev. Rul. 74-413, 1974-2 C.B. 333 (services performed in unemployment relief program under Manpower Development and Training Act); Rev. Rul. 69-519, 1969-2 C.B. 185 (services performed by apprentices for contractors, in union/employer apprenticeship program); Rev. Rul. 68-494, 1968-2 C.B. 432 (services performed in vocational training program); Rev. Rul. 68-541, 1968-2 C.B. 456 (services performed by students in high school vocational education program). Payments in these situations are taxable to the employer, to whom the individual provides services and who provides payment to the individual, even though the employer may be reimbursed by a third party for all or part of the remuneration paid.

Where payment by a state or other agency is to enable the recipient to participate in a training program, however, it may not be taxable. "Pre-apprentices" in the apprenticeship program involved in Rev. Rul. 69-519, for example, were paid for attending school, had their registration paid, and were furnished materials and supplies. The ruling concluded the "pre-apprentices" were not employees, the payments were not "remuneration for employment," and the payments were accordingly not taxable. Program payments may also be in the nature of unemployment relief, and not for performing services, and be non-taxable for that reason. See, e.g., Rev. Rul. 63-136, 1963-2 C.B. 19.

Finally, two somewhat anomalous rulings conclude that even where payments were for services performed, they were not taxable wages, due to the lack of an employer-employee relationship. These rulings, one dealing with federal prison inmates, Rev. Rul. 75-325, 1975-2 C.B. 415, and one with patients in Veterans Administration facilities, Rev. Rul. 65-18, 1965-1 C.B. 32, are apparently based on a reading of Congressional intent not to create an employer-employee relationship in the narrow circumstances addressed.

Payments to disabled persons performing services in "sheltered workshops" illustrate the principles in these rulings, as well as the confusion of theories sometimes found. Rev. Rul. 65-165, 1965-1 C.B. 446, discusses three factual settings. The ruling involved a sheltered workshop which provided training, rehabilitation, and employment to blind persons. "Class 1" individuals received orientation and training as part of a rehabilitation program to prepare them for private employment. Work hours were set to accustom the individual to industrial working conditions; the work situation involved training and was accompanied by counseling and other treatment, as needed. Trainees received "allowances," and were ineligible for benefits available to "regular" workshop employees. The ruling concluded an employer-employee relationship was lacking on these facts, due to a lack of "direction and control."

In contrast, "Class 2" consisted of individuals who had completed training and were awaiting placement in outside industry or were unable to secure private employment. The organization provided these workers pay and working benefits comparable to those in private industry, fixed working hours and production schedules, and could discharge workers for unsatisfactory performance. In these circumstances, the ruling concluded, the workers were employees of the organization. Finally, "Class 3" individuals worked at home, free of direction and control by the organization, and were held not to be its employees.

4. Employer-Employee Relationships

A. Introduction

The classification the relationship between workers and those who compensate them is a task having three parts: (1) determining if the payee is an "employee"; (2) determining if the payor is an "employer"; and (3) assuming there is an employment relationship, determining if relief is available to the employer under Section530 of the Revenue Act of 1978 (as amended).

B. Meaning of "Employee"

In general: By and large, the Code's employment tax provisions do not define the "employees" whose remuneration are the subject of those provisions. (Certain classes of workers - "statutory employees" - are employees by definition, for certain purposes. See IRC 3121(d)(3). This article does not discuss most classes of statutory employees.)

IRC 3121(d)(2) (FICA) defines the term "employee" to include "any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee...." IRC 3306(i) (FUTA) adopts this definition by reference. No similar definition is provided in the Code for ITW purposes.

Reg. 31.3121(d)-1(c)(2) is slightly more expensive:

> Generally, [a common law employer-employee] relationship exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished but also as to the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the employer not only as to what shall be done but how it shall be done. In this connection, it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if he has the right to do so. The right to discharge is also an important factor indicating that the person possessing that right is an employer. Other factors characteristic of an employer, but not necessarily present in every case, are the furnishing of tools and the furnishing of a place to work, to the individual who performs the services. In general, if an individual is subject to the control or direction of another merely as to the result to be accomplished by the work and not as to the means and methods for accomplishing the result, he is an independent contractor. An individual performing services as an independent contractor is not as to such services an employee under the usual common law rules. Individuals such as physicians, lawyers, artists, veterinarians, construction contractors, public stenographers, and auctioneers, engaged in the pursuit of an independent trade, business, or profession, in which they offer their services to the public, are independent contractors and not employees.

See also Reg. 31.3306(i)-1(b) (FUTA - same); Reg. 31.3401(c)-1(b)(ITW - same).

The regulations provide that the parties' description of the relationship as other than that of employer and employee is immaterial, if that relationship in fact exists. Reg. 31.3121(d)-1(a)(3) (FICA); 31.3306(i)-1(d) (FUTA); 31.3401(c)-1(e)(ITW). Whether the relationship exists will in doubtful cases be determined by examining the

particular facts of the case. Reg. 31.3121(d)-1(c)(3) (FICA); 31.3306(i)-1(c) (FUTA); 31.3401(c)-1(d) (ITW).

These provisions underlie the 20 "common law factors" used in determining whether an employment relationship exists. See IRM 4600, Exhibit 4640-1. In considering these factors, one must remember that each is relevant only to the extent it tends to prove (or disprove) the key fact required by the regulations: the payor's "right to control and direct the individual who performs the services, not only as to the result to be accomplished but also as to the details and means by which that result is accomplished."

The 20 factors, as delineated in Rev. Rul. 87-41, 1987-1 C.B. 296, are as follows:

1. ***Instructions.*** A worker who is required to comply with other persons' instructions about when, where, and how he or she is to work is ordinarily an employee. The control factor is present if the person or persons for whom the services are performed have the right to require compliance with instructions. See, for example, Rev. Rul. 68-598, 1968-2 C.B. 464, and Rev. Rul. 66-381, 1966-2 C.B. 449.

2. ***Training.*** Training a worker by requiring an experienced employee to work with the worker, by corresponding with the worker, by requiring the worker to attend meetings, or by using other methods, indicates that the person or persons for whom the services are performed want the services performed in a particular method or manner. See Rev. Rul. 70-630, 1970-2 C.B. 229.

3. ***Integration.*** Integration of the worker's services into the business operations generally shows that the worker is subject to direction and control. When the success or continuation of a business depends to an appreciable degree upon the performance of certain services, the workers who perform those services must necessarily be subject to a certain amount of control by the owner of the business. See United States v. Silk, 331 U.S. 704 (1947), 1947-2 C.B. 167.

4. ***Services Rendered Personally.*** If the services must be rendered personally, presumably the person or persons for whom the services are performed are interested in the methods used to accomplish the work as well as in the results. See Rev. Rul. 55-695, 1955-2 C.B. 410.

5. ***Hiring, Supervising, and Paying Assistants.*** If the person or persons for whom the services are performed hire, supervise, and pay assistants, that factor generally shows control over the workers on the job. However, if one worker hires, supervises, and pays other assistants pursuant to a contract under which the worker agrees to provide materials and labor and under which the worker is

responsible only for the attainment of a result, this factor indicates an independent contractor status. Compare Rev. Rul. 63-115, 1963-1 C.B. 178, with Rev. Rul. 55-593, 1955-2 C.B. 610.

6. ***Continuing Relationship.*** A continuing relationship between the worker and the person or persons for whom the services are performed indicates that an employer-employee relationship exists. A continuing relationship may exist where work is performed at frequently recurring although irregular intervals. See United States v. Silk.

7. ***Set Hours of Work.*** The establishment of set hours of work by the person or persons for whom the services are performed is a factor indicating control. See Rev. Rul. 73-591, 1973-2 C.B. 337.

8. ***Full Time Required.*** If the worker must devote substantially full time to the business of the person or persons for whom the services are performed, such person or persons have control over the amount of time the worker spends working and impliedly restrict the worker from doing other gainful work. An independent contractor, on the other hand, is free to work when and for whom he or she chooses. See Rev. Rul. 56-694, 1956-2 C.B. 694.

9. ***Doing Work on Employer's Premises.*** If the work is performed on the premises of the person or persons for whom the services are performed, that factor suggests control over the worker, especially if the work could be done elsewhere. Rev. Rul. 56-660, 1956-2 C.B. 693. Work done off the premises of the person or persons receiving the services, such as at the office of the worker, indicates some freedom from control. However, this fact by itself does not mean that the worker is not an employee. The importance of this factor depends on the nature of the services involved and the extent to which an employer generally would require that employees perform such services on the employer's premises. Control over the place of work is indicated when the person or persons for whom the services are performed have the right to compel the worker to travel a designated route, to canvass a territory within a certain time, or to work at specific places as required. See Rev. Rul. 56-694.

10. ***Order or Sequence Set.*** If a worker must perform services in the order or sequence set by the person or persons for whom the services are performed, that factor shows that the worker is not free to follow the worker's own pattern of work but must follow the established routines and schedules of the person or persons for whom the services are performed. Often, because of the nature of an occupation, the person or persons for whom the services are performed do not set the order of the services or set the order infrequently. It is sufficient to show control, however, if such person or persons retain the right to do so. See Rev. Rul. 56-694.

11. ***Oral or Written Reports.*** A requirement that the worker submit regular or written reports to the person or persons for whom the services are performed indicates a degree of control. See Rev. Rul. 70-309, 1970-1 C.B. 199, and Rev. Rul. 68-248, 1968-1 C.B. 431.

12. ***Payment by Hour, Week, Month.*** Payment by the hour, week, or month generally points to an employer-employee relationship, provided that this method of payment is not just a convenient way of paying a lump sum agreed upon as the cost of a job. Payment made by the job or on a straight commission generally indicates that the worker is an independent contractor. See Rev. Rul. 74-389, 1974-2 C.B. 330.

13. ***Payment of Business and/or Traveling Expenses.*** If the person or persons for whom the services are performed ordinarily pay the worker's business and/or traveling expenses, the worker is ordinarily an employee. An employer, to be able to control expenses, generally retains the right to regulate and direct the worker's business activities. See Rev. Rul. 55-144, 1955-1 C.B. 483.

14. ***Furnishing of Tools and Materials.*** The fact that the person or persons for whom the services are performed furnish significant tools, materials, and other equipment tends to show the existence of an employer-employee relationship. See Rev. Rul. 71-524, 1971-2 C.B. 346.

15. ***Significant Investment.*** If the worker invests in facilities that are used by the worker in performing services and are not typically maintained by employees (such as the maintenance of an office rented at fair value from an unrelated party), that factor tends to indicate that the worker is an independent contractor. On the other hand, lack of investment in facilities indicates dependence on the person or persons for whom the services are performed for such facilities and, accordingly, the existence of an employer-employee relationship. See Rev. Rul. 71-524. Special scrutiny is required with respect to certain types of facilities, such as home offices.

16. ***Realization of Profit or Loss.*** A worker who can realize a profit or suffer a loss as a result of the worker's services (in addition to the profit or loss ordinarily realized by employees) is generally an independent contractor, but the worker who cannot is an employee. See Rev. Rul. 70-309. For example, if a worker is subject to a real risk of economic loss due to significant investments or a bona fide liability for expenses, such as salary payments to unrelated employees, that factor indicates that the worker is an independent contractor. The risk that a worker will not receive payment for his or her services, however, is common to both independent contractors and employees and thus does not constitute a sufficient economic risk to support treatment as an independent contractor.

17. ***Working for More Than One Firm at a Time.*** If a worker performs more than de minimis services for a multiple of unrelated persons or firms at the same time,

that factor generally indicates that the worker is an independent contractor. See Rev. Rul. 70-572, 1970-2 C.B. 221. However, a worker who performs services for more than one person may be an employee of each of the persons, especially where such persons are part of the same service arrangement.

18. ***Making Service Available to General Public.*** The fact that a worker makes his or her services available to the general public on a regular and consistent basis indicates an independent contractor relationship. See Rev. Rul. 56-660.

19. ***Right to Discharge***. The right to discharge a worker is a factor indicating that the worker is an employee and the person possessing the right is an employer. An employer exercises control through the threat of dismissal, which causes the worker to obey the employer's instructions. An independent contractor, on the other hand, cannot be fired so long as the independent contractor produces a result that meets the contract specifications. See Rev. Rul. 75-41, 1975-1 C.B. 323.

20. ***Right to Terminate.*** If a worker has the right to end his or her relationship with the person for whom the services are performed at any time he or she wishes without incurring liability, that factor indicates an employer-employee relationship. See Rev. Rul. 70-309.

Specific situations: Appendix B-I to this article discusses classification of specific types of workers in published precedents. This discussion is not comprehensive, and is further limited to precedents particularly relevant to exempt organizations. This Appendix may be used as a research tool, but should not substitute for independent research and application of general principles to the facts of a particular case.

C. Meaning of "Employer"

ITW: "Employer" is defined generally in the employment tax provisions of the Code only for ITW purposes. IRC 3401(d)(1) provides that the term means a person for whom an individual performs (or performed) services as an employee; if that person does not control payment of wages, however, the term means the person having control. See also Reg. 31.3401(d)-1(a), (f). Reg. 31.3401(d)-1(b) states that a person for whom services were performed in the past continues to be an employer so long as wages are being paid to the employee. Exempt organizations, and governmental units, agencies, and instrumentalities, are specifically included in the definition of "employer." See Reg. 31.3401(d)-1(d).

Persons controlling the payment of wages may include trusts (such as voluntary employee beneficiary associations) which pay benefits which are taxable

"wages." See, e.g., Rev. Rul. 73-22, 1973-1 C.B. 410. Also, payments of taxable supplemental unemployment compensation by a person other than the employer are subject to withholding by the payor. See IRC 3402(o)(1)(A); Reg. 31.3401(d)-1(g). Payments of taxable deferred compensation and retirement pay are also subject to withholding as if they were wages paid by the payor. See IRC 3405; Reg. 35.3405-1T.

Under IRC 3505(a), a lender, surety, or other person who pays wages directly to employees of an employer is treated as an employer for ITW purposes. See Rev. Proc. 78-13, 1978-1 C.B. 591; Reg. 31.3505-1. Similarly, withholding agents, authorized pursuant to IRC 3504, are treated as employers. See Reg. 31.3504-1.

FICA/FUTA: The FICA regulations provide generally that an "employer" is a person who employs one or more employees. See Reg. 31.3121(d)-2(a). A similar definition applies for FUTA purposes. See IRC 3306(a). A person who controls the payment of wages, however, is not (as for ITW purposes) considered an employer solely on that basis. Thus, in Rev. Rul. 73-253, 1973-1 C.B. 414, race track stewards, who acted as representatives of a state horse racing board, were employees of the board for FICA and FUTA purposes; however, for ITW purposes, they were employees of the racing association which controlled the payment of their compensation.

Third parties who pay sick pay are treated as employers with respect to amounts paid. IRC 3121(a) (last sentence); IRC 3306(b) (last sentence).

It is possible that someone other than the common law employer may be responsible for the federal employment taxes (i.e., the employer FICA taxes, FUTA tax, and proper withholding of FICA and income tax on wages paid to employees). IRC 3401(d)(1) provides, for purposes of income tax withholding, that if the person for whom an individual performs services as an employee "does not have control of the payment of wages for such services," the term "employer" then means "the person having control of the payment of such wages." This is intended to place responsibility for withholding at the point of control of the payment. This rule also applies to the other employment taxes, including the FICA and FUTA. See Otte v. United States, 419 U. S. 43, 51, (1974), 1975-1 C.B. 329, 332; In re Armadillo Corp., 410 F. Supp. 407 (D. Colo. 1976), aff'd, 561 F.2d 1382 (10th Cir. 1977).

Common paymaster: IRC 3121(s) (FICA) and IRC 3306(p) (FUTA) provide that where related corporations concurrently employ an individual who is compensated through a "common paymaster," each corporation is considered to have

paid as remuneration only amounts actually disbursed by it. Thus, if the common paymaster actually disburses all remuneration, it is the sole employer. See Reg. 31.3121(s)-1(a); Reg. 31.3306(p)-1(a).

For remuneration paid after December 31, 1983, section 125(a) of P.L. 98-21 (Apr. 20, 1983), provides that the following shall be deemed to be related corporations, for purposes of IRC 3121(s):

> (A) A state university which employs health professionals as faculty members at a medical school, and
>
> (B) A faculty practice plan described in IRC 501(c)(3) and exempt under IRC 501(a)--
>
> > (i) which employs faculty members of the medical school, and
> >
> > (ii) 30 percent or more of whose employees are concurrently employed by the medical school.

If this provision applies, remuneration paid by the faculty practice plan to health professionals commonly employed by it and the university is deemed to have been disbursed by the university as common paymaster.

Professional service corporations: The use of professional service corporations to serve as an intermediary between an individual and the business to which he/she provides services, is an area of particular concern. Assignment of income principles apply in the employment tax context. Thus, Rev. Rul. 80-321, 1980-2 C.B. 33, held that where an individual assigned his "lifetime services" to a trust, which then entered into a "professional services contract" with the individual's employer, the employer, not the trust, was the individual's employer for employment tax purposes. This approach has not been entirely successful in the courts, however. See, e.g., Sargent v. Commissioner, 929 F.2d 1252 (8th Cir. 1991), rev'g 93 T.C. 572 (1989) (services of professional hockey player were performed as employee of PSC, not team). (At the time of printing, no decision had been made with regard to the Service's response to the Court of Appeals' decision.)

Specific situations: Appendix B-II discusses precedents on who is the employer of an admitted "employee," in specific situations. Note again that this discussion is not comprehensive.

D. Section 530 of the Revenue Act of 1978

In the late 1960's, the Service increased enforcement of the employment tax laws. As a result, many controversies arose over whether workers were employees or independent contractors. A successful effort by the Service to reclassify workers as employees, who are treated by a taxpayer as independent contractors, results in employer liability for withholding and employment tax amounts already paid out to employees. Although employers may generally offset self-employment or income taxes paid by employees, see IRC 3402(d), they may have difficulty proving claimed offsets. Finally, in some cases the Service asserted inconsistent positions in separate examinations of employers and individual workers. See generally H.R. Rep. No. 95-1748, 95th Cong., 2d Sess. (Oct. 10, 1978).

Prompted by these concerns, Congress enacted Section 530 of the Revenue Act of 1978, P.L. 95-600, 95th Cong., 2d Sess. (Nov. 6, 1978). Originally designed as a "temporary" relief measure, Section 530 has been amended and extended several times; the Tax Equity and Fiscal Responsibility Act of 1982, Section 269, P.L. 97-248, 97th Cong., 2d Sess. (Aug. 17, 1982), extended it indefinitely. (In addition to granting relief from employment taxes in certain cases, section 530, in subsection (c), prohibits the Service from issuing regulations and revenue rulings of general application on the common law status of employees.)

Section 530(a)(1) says that if, for employment tax purposes, a taxpayer did not treat an individual as an employee for any period, the individual will be deemed not to be an employee for that period, unless the taxpayer had no reasonable basis for not treating the individual as an employee. In other words, the employer is relieved from employment taxes with respect to that individual. It is important to note that section 530 is intended to provide relief for the employer and does not change the status of the worker. The worker remains a common law employee.

For periods after December 31, 1978, relief is available only if (1) all federal tax returns (including information returns) required to be filed by the taxpayer with respect to the individual for the period are filed on a basis consistent with the individual not being an employee ("reporting consistency rule"); and (2) the taxpayer (and any predecessor) has not treated any individual holding a substantially similar position as an employee, for employment tax purposes, for periods beginning after December 31, 1977 ("substantive consistency rule").

Section 530(a)(2) provides three "safe havens" establishing "reasonable basis" for not treating an individual as an employee. "Reasonable basis" exists if the taxpayer reasonably relies on (a) judicial precedent, published rulings, or technical

advice memorandum or letter ruling with respect to the taxpayer; (b) prior Service audit of the taxpayer in which employment tax deficiencies were not assessed for amounts paid individuals holding positions substantially similar to that held by the individual in question; or (c) long-standing recognized practice of a significant segment of the industry in which the individual was employed.

Rev. Proc. 85-18, 1985-1 C.B. 518, provides instructions for implementing Section 530:

Reporting consistency rule

To satisfy the reporting consistency rule, the appropriate Form 1099 must be filed with respect to workers treated as non-employees, i.e., as independent contractors. See Rev. Rul. 81-224, 1981-2 C.B. 197; Rev. Proc. 85-18, Section 3.02.

An individual is "treated" as an employee, for purposes of Section 530(a)(1), if--

(1) The employer withholds income tax (whether or not withheld amounts are paid over to the government). Rev. Proc. 85-18, Section 3.03(A).

(2) The employer files employment tax returns (Forms 940, 941, 942, 943, and W-2) with respect to an individual (whether or not taxes were withheld). Rev. Proc. 85-18, Section 3.03(B).

An individual is not "treated" as an employee, however, if the filing of employment tax returns results from Service compliance procedures, Rev. Proc. 85-18, Section 3.03(C), or consists of returns prepared by the Service under IRC 6020(b), id., Section 3.03(E). Service Center notices that returns have not been filed are not "compliance procedures," however. Id., Section 3.03(D). A taxpayer who begins treating individuals as employees is not thereby precluded from relief for prior periods. See id., Section 3.04.

Substantive consistency rule

Judicial precedent, published rulings, or TAM/PLR: A judicial precedent or published ruling need not relate to the specific industry or business in which the taxpayer is engaged. Rev. Proc. 85-18, Section 3.01(A).

Prior audit: A prior audit need not have been for employment tax purposes. Rev. Proc. 85-18, Section 3.01(B). A taxpayer does not meet the prior audit standard

if employment tax liability was determined to exist in a prior audit with respect to similarly situated workers, but was offset by other claims. Id.

Industry practice: The practice must be that of a significant segment of the industry, but need not be uniform through an entire industry. Rev. Proc. 85-18, Section 3.01(C).

The Service is expected to publish additional guidance on the "prior audit" and "industry practice" safe havens in the near future.

A taxpayer who does not meet one of the "safe havens" may be entitled to relief if it can demonstrate other "reasonable basis" for not treating an individual as an employee. No relief is available, however, where a taxpayer fails to treat individuals as employees for a reason other than a belief they are independent contractors. Thus, in Rev. Rul. 82-116, 1982-1 C.B. 152, an employee who failed to treat illegal aliens as employees because they had no Social Security numbers was not entitled to Section 530 relief.

Procedures for refunds, credits, and abatement of taxes, pursuant to the relief provisions of Section 530, are provided by Rev. Proc. 85-18, Section 3.05-.07.

Section 1706(a) of the Tax Reform Act of 1986 added Section 530(d), providing an exception from the relief provisions. Under Section 530(d), Section 530 does not apply with respect to an individual who, under an arrangement between the taxpayer and a third party, provides services for the third party as an engineer, designer, drafter, computer programmer, systems analyst, or other similarly skilled worker engaged in a similar line of work. This provision eliminates the availability of relief under Section 530 to the taxpayer with respect to the defined categories of workers; whether such workers are employees or independent contractors is determined under the usual common law rules. See Rev. Rul. 87-41, 1987-1 C.B. 296.

5. Employment Tax Exceptions

A. Introduction

Employment tax exceptions fall into three categories. Some are based on the nature of the employer for whom services are rendered, some on the employee's status, and some on the nature of the service. Most are exceptions from the definition

of taxable wages or services. Any given exception may not apply for FICA, FUTA, and ITW purposes.

In discussing exceptions, this section uses the basis of the exception (employer, employee, nature of service) as an organizing technique. The discussion notes how each exception is provided (as an exception from the definition of taxable wages, for example), which may be significant in determining other consequences (e.g., whether service is exempt because more than half the remuneration is taxable wages). Exceptions with little relevance to exempt organizations are not discussed.

Rev. Rul. 72-202, 1972-1 C.B. 314, does not readily fit into any category discussed below. This ruling held that campaign workers employed by a candidate for public office were excepted from FICA and FUTA taxes because they performed services which were not in the "trade or business" of the employer, and earned less than $50 in the calendar quarter. See IRC 3121(a)(7)(C); IRC 3306(b)(7) (which now provides for exemption only for non-cash remuneration). Service by workers employed by a corporation a candidate established to promote his election were not excepted, however. Many organizations exempt under IRC 527(a) are separate organizations, to which the "no trade or business" exception is unavailable.

B. Employer-Based Exceptions

Churches and church-controlled organizations

Service performed for a church or a "qualified church-controlled organization" is excepted from the definition of "employment" for FICA purposes if the church or organization has in effect an election under IRC 3121(w). Thus, wages for services performed for a church or qualified church-controlled organization are subject to FICA unless the church or organization has "elected-out" pursuant to that section. IRC 3121(w)(3)(A) defines the term "church," and IRC 3121(w)(3)(B) defines "qualified church-controlled organizations" for this purpose.

Other exempt organizations

501(c)(3) organizations: Service performed for organizations exempt under IRC 501(c)(3) is excepted from the definition of "employment" for FUTA purposes only. See IRC 3306(c)(8). Before 1984, service performed for 501(c)(3) organizations was excepted from FICA under certain circumstances; this exception is now of little relevance.

Other organizations: Remuneration of less than $100 earned in a calendar year for services performed for organizations exempt under IRC 501(a) (other than organizations described in IRC 401(a)) or under IRC 521 is exempt from FICA. IRC 3121(a)(16). Such service is excepted from "employment," for FUTA purposes, if remuneration is less than $50 during a quarter. IRC 3306(c)(10)(A).

International organizations

Service in the employ of an "international organization" is excepted from the definition of "employment" for FICA, IRC 3121(b)(15), and FUTA, IRC 3306(b)(16), purposes. These are organizations entitled to privileges, exemptions, and immunities under the International Organizations Immunities Act, 22 U.S.C. Sections 288-288f. See IRC 7701(a)(18).

State and local governments and their instrumentalities

Services performed in the employ of a state, a political subdivision thereof, or a wholly-owned instrumentality of either, are excepted from the definition of "employment" for FICA, IRC 3121(b)(7), and FUTA, IRC 3306(c)(7), purposes. While the FUTA exception is absolute, the FICA exception has significant exceptions (and there are exceptions to the exception).

Covered transportation services: Services defined in IRC 3121(j) are not excepted. IRC 3121(b)(7)(A).

District of Columbia: Service in the employ of the District of Columbia, or its instrumentalities, is excepted only if covered by a retirement system established by law of the United States (with certain exceptions). IRC 3121(b)(7)(C).

Service covered by state compact with Social Security Administration: If services have been included under an agreement entered into pursuant to Section 218 of the Social Security Act, such services are subject to FICA. IRC 3121(b)(7)(E).

Medicare tax: IRC 3121(u)(2) applies Medicare tax to state and local employment, with exceptions. The tax applies only if no Section 218 agreement is in effect, IRC 3121(u)(2)(B)(i), and only to individuals hired after March 31, 1986, IRC 3121(u)(2)(C). Service by defined classes of employees is also excepted. See IRC 3121(u)(2)(B)(ii). Rev. Rul. 86-88, 1986-2 C.B. 172, supplemented, Rev. Rul. 88-36, 1988-1 C.B. 343, provides guidelines on the applicability of the Medicare tax to state and local employees.

Post-7/1/91 service: After July 1, 1991, service for state and local governments, and their instrumentalities, will generally be excepted from FICA only for employees who are members of a retirement system of their employer. See IRC 3121(b)(7)(F). New regulations require that a retirement system provide a minimum level of retirement benefits (generally, one comparable to the basic retirement benefit under Social Security), for the exception to apply. The Service has also published a revenue procedure describing "safe harbor" formulas that satisfy the minimum benefit requirements set forth in the proposed regulations. See Rev. Proc. 91-40, 1991-28 I.R.B. 30.

The criteria used to determine if an organization is an "instrumentality" are discussed in the 1990 CPE article on Instrumentalities. The following additional precedents are noted:

Hospitals: Rev. Rul. 56-173, 1956-1 C.B. 480, and Rev. Rul. 56-174, 1956-1 C.B. 481, discuss whether hospitals are "instrumentalities."

Libraries: Rev. Rul. 56-88, 1956-1 C.B. 464, and Rev. Rul. 56-89, 1956-1 C.B. 465, discuss whether libraries are "instrumentalities."

Volunteer fire departments: Rev. Rul. 70-483, 1970-2 C.B. 201, and Rev. Rul. 70-484, 1970-2 C.B. 202, discuss whether volunteer fire departments are "instrumentalities."

School: Rev. Rul. 56-224, 1956-1 C.B. 485, discusses whether a school is an "instrumentality."

As discussed in the 1990 CPE text, while a wholly-owned instrumentality may qualify for exception under IRC 501()(3), its liability for FICA is determined on its status as an "instrumentality." See Rev. Rul. 55-319, 1955-1 C.B. 119.

IRC 3125 and 3126 provide special rules for returns of FICA taxes by governmental employers.

C. Employee-Based Exceptions

Interns

Service performed as an intern in a hospital by an individual who has completed a four-year medical school course chartered or approved by state law, is excepted from "employment" for FUTA purposes only. IRC 3306(c)(13).

Ministers and members of religious orders

Service performed by a duly ordained, commissioned, or licensed minister of a church in the exercise of his ministry, or by a member of a religious order in the exercise of duties required by such order, are generally excepted from the definition of "employment" for FICA purposes. IRC 3121(b)(8). A similar exception, from the definition of "wages," is provided for ITW purposes. IRC 3401(a)(9). (Although no parallel FUTA exemption is provided, service by ministers and members of religious orders is presumably within the general exemption for 501(c)(3) organizations.) FICA coverage may be elected by religious orders whose members are under a vow of poverty, under to IRC 3121(r). See also Reg. 31.3121(r)-1.

The regulations provide rules for determining if a minister's services are performed in the exercise of his ministry. See Reg. 31.3121(b)(8)-1(b)-(c) (FICA); Reg. 31.3401(a)(9)-1(b)-(c) (ITW). Additional precedents are discussed in the Compensation topic in the 1990 CPE text.

With service performed by members of religious orders, the nature of the service is immaterial, if it is required by the individual's ecclesiastical superiors. Reg. 31.3121(b)(8)-1(d) (FICA); Reg. 31.3401(a)(9)-1(d). Services must be of a type which is ordinarily the duty of a member of the order, however, and must be performed as a duty for or on behalf of the order as its agent. See Rev. Rul. 76-323, 1976-2 C.B. 18, clarified, Rev. Rul. 77-290, 1977-2 C.B. 26, and amplified, Rev. Rul. 79-132, 1979-1 C.B. 62, and amplified, Rev. Rul. 80-332, 980-2 C.B. 34 (service as plumbers and construction workers was not within the exception).

For elective coverage under IRC 3121(r), IRC 3121(i)(4) defines "wages" as including the fair market value of "board, lodging, clothing, and other perquisites" furnished members of the order; the amount included in "wages" under this special definition may not be less than $100/month. See also Reg. 31.3121(i)-4.

Rev. Proc. 91-20, 1991-10 I.R.B. 26, provides the following list of "characteristics" of a religious order, to be used in determinations, inter alia, under IRC 3121(b)(8)(A) and 3401(a)(9):

1. The organization is described in section 501(c)(3) of the Code.

2. The [members] of the organization vow to live under a strict set of rules requiring moral and spiritual self-sacrifice and dedication to the goals of the organization at the expenses of their material well-being.

3. The members of the organization, after successful completion of the organization's training program and probationary period, make a long-term commitment to the organization (normally more than two years).

4. The organization is, directly or indirectly, under the control and supervision of a church or convention or association of churches, or is significantly funded by a church or convention or association of churches.

5. The members of the organization normally live together as part of a community and are held to a significantly stricter level of moral and religious discipline than that required of lay church members.

6. The members of the organization work or serve full-time on behalf of the religious, educational, or charitable goals of the organization.

7. The members of the organization participate regularly in activities such as public or private prayer, religious study, teaching, care of the aging, missionary work, or church reform or renewal.

Generally, the presence of all of these factors is determinative that the organization is a religious order; and the absence of the first factor (501(c)(3) organization) is determinative that it is not. If application of these characteristics in a particular case does not clearly indicate the organization's nature, the Service will generally contact appropriate authorities affiliated with the organization concerning the characterization of the organization and their views will be carefully considered.

Newspaper/magazine delivery persons

Service performed by someone under age 18 delivering or distributing newspapers or shopping news (not for re-distribution) is excepted from "employment" for FICA, IRC 3121(b)(14)(A), FUTA, IRC 3306(b)(15)(A), and ITW, IRC 3401(a)(12)(A), purposes. In addition, service performed by someone selling newspapers or magazines to ultimate consumers is excepted, IRC 3121(b)(14)(B) (FICA), 3306(b)(15)(B) (FUTA), 3401(a)(12)(B), if under an arrangement whereby sales are at a fixed price and compensation is based on the difference between the price paid and the fixed price.

Non-resident aliens

Service performed by non-resident aliens temporarily present in the United States under subparagraph (F), (J), or (M) of Section 101(a)(15) of the Immigration and Nationality Act, for such purposes, is excepted from "employment" for FICA, IRC 3121(b)(19), and FUTA, IRC 3306(b)(19), purposes. The regulations describe these provisions more fully. See Reg. 31.3121(b)(19)-1.

IRC 3401(a)(6) excepts from "wages" services performed by nonresident aliens, as designated by regulations. The designated exceptions, see Reg. 31.3401(a)(6)-2, differ significantly from exceptions available for FICA and FUTA purposes.

Student Nurses

Service as a student nurse is excepted from "employment" for FICA, IRC 3121(b)(13), and FUTA, IRC 3306(b)(13), purposes. Excepted service is that performed "as a student nurse in the employ of a hospital or a nurses' training school by an individual who is enrolled and is regularly attending classes in a nurses' training school chartered or approved pursuant to State law."

Rev. Rul. 85-74, 1985-1 C.B. 331, says three requirements must be met for this exception to apply:

(1) The employment must be substantially less than full-time;

(2) The total amount of earnings must be nominal; and

(3) The only services performed by the student nurse for the employer must be incidental parts of the nurse's training toward a degree which will qualify him/her to practice as a nurse or in specialized areas of nursing.

Service involved in this ruling was not excepted, where the nurse worked full-time, earned a salary which was not nominal, and performed services which were not part of the training.

A recent technical advice memorandum, PLR 8942005 (July 14, 1989), supplemented, PLR 9030002 (Apr. 5, 1990), which follows Rev. Rul. 85-74, has been controversial. The Service has been called on to defend this technical advice memorandum (and Rev. Rul. 85-74), in Congressional hearings, and legislation has

been introduced on this issue. (Pursuant to IRC 6110(j)(3), technical advice memoranda may not be used or cited as precedent.)

In PLR 8942005, a hospital requested a refund of FICA taxes paid for workers who performed services for it while enrolled in classes at a nursing school or university. Refunds were requested for nurses who met three of five criteria: (1) the individual's name and Social Security number on the payroll matched those on the school roster; (2) the individual attended classes during the years involved; (3) the individual changed jobs as a result of pursuing a degree; (4) the individual changed from part-time to full-time employment; and (5) the individual's pay increased substantially as the individual's job changed. The Service concluded these criteria were unacceptable for determining eligibility for the student nurse exemption; since the hospital had not documented that it satisfied the criteria in Rev. Rul. 85-74, the exemption was not available.

Students

Service by certain students in the employ of a school, college, or university (or a 509(a)(3) organization supporting such an institution) is excepted from "employment" for FICA, IRC 3121(b)(10), and FUTA, IRC 3306(c)(10)(B), purposes. For both FICA and FUTA, the student must be "enrolled and regularly attending classes at" the institution; the FUTA exemption also extends to spouses of students, if certain conditions are met. Services by full-time students participating in a work-study program, for up to 15 hours/week, were held exempt in Rev. Rul. 66-285, 1966-2 C.B. 455. Services performed for a third party (who is the "employer") do not qualify, however. See Rev. Rul. 55-500, 1955-2 C.B. 398. Students who are not enrolled in any courses (including dissertation) during a particular term (including summer terms) do not qualify as "full-time" students. See Rev. Rul. 74-109, 1974-1 C.B. 288; Rev. Rul. 72-142, 1972-1 C.B. 317.

The regulations say services are excepted only if performed "as an incident to and for the purpose of pursuing a course of study ...." Reg. 31.3121(b)(10)-2(c) (FICA); Reg. 31.3306(c)(10)-2(c)(2) (FUTA). Rev. Rul. 78-17, 1978-1 C.B. 306, considered when employment is "incident to" pursuing a course of study. The ruling held that two of three students considered did qualify: Student A, who was enrolled in a Master's program for four courses totaling 12 credits, while working 15 hours/week; and Student C, who was enrolled in a doctoral program and actively working on a dissertation (for which C was currently enrolled), while working six hours/week. Student B, however, who was registered for only two courses totaling six credits

while working full-time, was not performing services "as an incident to" a course of study.

Service by students in the employ of organized camps is excepted from "employment" for FUTA purposes only. IRC 3306(c)(20). Service is excepted if performed by a "full-time student"; IRC 3306(q) defines this term as including only periods when the student is enrolled as a full-time student, or between academic periods if the student was enrolled full-time at an educational institution for the preceding term and there is reasonable assurance that he/she will be so-enrolled for the succeeding term. Note that a summer music camp operated as part of a university was held to be a "school" for purposes of applying the exemption in IRC 3121(b)(10), discussed above.

D. Service-Based Exemptions

Agricultural labor

Remuneration for "agricultural labor" is excepted from "wages" for FICA purposes, IRC 3121(a)(8), (A) if paid in any medium other than cash, or (B) if less than $150 in a year, or the employer's expenditures for such labor in a year are less than $2,500. Service in "agricultural labor" is excepted both from "employment," IRC 3306(b)(1), and "employer," IRC 3306(a)(2), for FUTA purposes, unless performed for a person (A) who pays cash remuneration of $20,000 or more to individuals employed in agricultural labor, or (B) employs 10 or more individuals in agricultural labor at some time during 20 weeks during the current or preceding calendar year. All service constituting agricultural labor and performed for non-cash remuneration is excepted from FUTA's definition of "wages," IRC 3306(b)(11).

"Agricultural labor" is defined in IRC 3121(g). IRC 3306(k) adopts this definition by reference, with minor modifications.

IRC 3401(a)(2) similarly excepts, for ITW purposes, "wages" for agricultural labor, unless the remuneration is wages as defined under IRC 3121(a) (see also IRC 3121(g)).

Employees of a non-profit mutual water company, which provides services primarily to farmers for irrigation purposes, are not involved in "agricultural labor," under these provisions. Rev. Rul. 71-293, 1971-2 C.B. 351. Environmental conservation activities likewise do not involve "agricultural labor." Rev. Rul. 57-217, 1957-1 C.B. 343.

Domestic service in certain college organizations

Certain domestic service in a local college clubs, or local chapters of a college fraternity or sorority, is excepted from the definition of "employment" for FICA purposes, IRC 3121(b)(2); "employment", IRC 3306(c)(2), and "employer," IRC 3306(a)(3), for FUTA purposes; and from "wages" for ITW purposes, IRC 3401(a)(3). The FICA exemption extends to students enrolled and regularly attending classes at a school, college, or university. The FUTA exemption covers any such service, but only if cash remuneration to all individuals employed in such service is less than $1,000 in any calendar quarter during the current or preceding calendar year. (This exception should not be confused with the treatment of cash wages paid to an employee for domestic service in a private home of the employer, which are subject to FICA.)

The regulations say excepted services are those "of a household nature in or about the club rooms or house" and include services rendered by "cooks, waiters, butlers, maids, janitors, laundresses, furnacemen, handymen, gardeners, housekeepers, and housemothers." Reg. 31.3121(b)(2)-1(b) (FICA); Reg. 31.3306(c)(2)-1(b)(2) (FUTA); Reg. 31.3401(a)(3)-1(b)(2) (ITW). Services for an alumni chapter of a local college club, fraternity, or sorority are not excepted, Reg. 31.3121(b)(2)-1(c), nor are those in rooming or lodging houses, boarding houses, clubs (except local college clubs), hotels, hospitals, eleemosynary institutions, or commercial offices or establishments, Reg. 31.3121(b)(2)-1(e) (FICA), 31.3306(c)(2)-1(c) (FUTA), 31.3401(a)(3)-1(c).

In Rev. Rul. 72-174, 1972-1 C.B. 315, the Service held that services performed by students in a university women's club, whose membership consisted of faculty and administration members, employees of affiliated organizations, and their family members, were not excepted. Similarly, Rev. Rul. 68-448, 1968-2 C.B. 481, held that payments to a sorority "housemother" for services performed during a university's summer term, when the house was used primarily to accommodate non-members, were not within this exception.

APPENDIX A

Taxable "Wages"

Back pay awards

Amounts paid under the Fair Labor Standards Act or Walsh-Healy Government Contracts Act to restore unpaid minimum wages and overtime are "remuneration for employment" (and taxable wages). Rev. Rul. 72-268, 1972-1 C.B. 313; see also Rev. Rul. 55-203, 1955-1 C.B. 114. Amounts representing liquidated damages for the employer's violation of these laws, however, are not wages.

Similarly, amounts paid under "back pay" orders of the National Labor Relations Board are taxable wages. Rev. Rul. 57-55, 1957-1 C.B. 304; see also Social Security Board v. Nierotko, 327 U.S. 358 (1946) (NLRB back pay award is wages for Social Security credit purposes), amplified, Rev. Rul. 75-64, 1975-1 C.B. 16 (back pay award solely against labor organization is income under IRC 61, but not taxable wages, where labor organization is not employer).

Amounts paid a discharged employee to settle an unlawful employment discrimination claim are dismissal or severance payments (see below), and taxable wages. Rev. Rul. 72-572, 1972-2 C.B. 535. Payments to persons wrongfully denied employment based on racial discrimination, which represent reparation of economic losses, are also taxable wages. Rev. Rul. 78-176, 1978-1 C.B. 303.

Payments (or portions thereof) designated as interest and attorney's fees are not taxable. Rev. Rul. 80-364, 1980-2 C.B. 294.

Back pay constitutes wages in the year received, and is subject to FICA, FUTA, and ITW at rates in effect at the time. See Rev. Rul. 89-35, 1989-1 C.B. 280.

Bonuses and incentive compensation

Christmas bonuses equal to a specified percentage of employees' monthly salaries are taxable wages. Rev. Rul. 71-53, 1971-1 C.B. 279. Bonuses paid in United States savings bonds are also taxable. Rev. Rul. 71-143, 1971-1 C.B. 280.

Incentive compensation to key employees under contractual arrangements to defer compensation is in the nature of a bonus, and taxable. Rev. Rul. 82-176, 1982-2 C.B. 223; Rev. Rul. 69-286, 1969-1 C.B. 253. Note, though, that payments under a deferred compensation plan of the employer may be excluded as retirement pay under some circumstances. See Rev. Rul. 77-25, 1977-1 C.B. 301, and the general discussion of retirement pay, below.

Commissions

Commissions paid employees for referring customers to the employer are taxable wages. Rev. Rul. 69-452, 1969-2 C.B. 181.

Employee taxes

FICA/FUTA: The employer's payment of the employee's FICA or state unemployment tax is not taxable wages, but only for pay for domestic service in the employer's private home or for agricultural labor. IRC 3121(a)(6) (FICA); IRC 3306(b)(2)(6) (FUTA). Other payments of taxes are taxable, since no exclusion exists.

ITW: Payment of employee taxes is taxable for ITW purposes. Reg. 31.3401(a)-1(b)(6).

Rev. Proc. 81-48, 1981-2 C.B. 623, provides a formula for determining the amount of taxable wages when an employer pays employee taxes. The formula avoids "pyramiding" of taxes which might otherwise result when taxes paid increased taxable wages, increasing taxes owed.

Expense accounts or allowances

Final regulations on employee expense accounts or allowances were published on December 17, 1990. See T.D. 8234, 1991-2 I.R.B. 4. These regulations, effective for amounts received by employees on or after July 1, 1990, for expenses paid or incurred on or after that date, provide that amounts which meet the requirements of IRC 62(c) and Reg. 1.62-2, and which are substantiated within a reasonable period of time, are excluded from taxable wages. See Reg. 31.3121(a)-1(h), 31.3121(a)-3 (FICA); Reg. 31.3306(b)-1(h), 31.3306(b)-2 (FUTA); Reg. 31.3401(a)-1(b)(2), 31.3401(a)-4 (ITW). The Service will not impose penalties for failing to comply with the employment tax provisions in connection with employee expense accounts or allowances before July 1, 1991, however, if the employer made a substantial and good faith effort to comply. Notice 90-74, 1991-2 I.R.B. 17.

Reg. 1.62-2 describes "accountable" expense plans. An accountable plan is an expense reimbursement or allowance arrangement which meets the following requirements:

(1) Business connection: The plan provides allowances or reimbursement only for expenses allowable as deductions by Part VI of the Code which are paid or incurred by the employee in performing services as an employee of the employer. Reg. 1.62-2(d)(1).

(2) Substantiation: The plan requires that each expense be substantiated, either in the manner required by IRC 274(d) (for certain travel and entertainment expenses), or by requiring that sufficient information be submitted to allow the payor to identify the specific nature of the expense and conclude the expense is attributable to its business activities. Reg. 1.62-2(e).

(3) Return of excess amounts: The plan requires the return, within a reasonable time, of amounts exceeding expenses substantiated in accordance with Reg. 1.62-2(e). Reg. 1.62-2(f).

The temporary regulations on which these regulations are based were explained in greater detail in the update to the 1990 Compensation article.

Foster care payments

Depending on the facts of a particular case, payments by state agencies or charitable organizations to foster parents may represent reimbursement for gratuitous services to the placing agencies in feeding, clothing, and caring for foster children; in that case, payments are not "wages." See Rev. Rul. 77-280, 1977-2 C.B. 14, modified on other grounds, Rev. Rul. 84-61, 1984-1 C.B. 39. (Where payments are compensatory, Rev. Rul. 77-280 concludes the foster parents are not "employees" of the placing agencies, and therefore not subject to the provisions.)

Guaranteed wage plan

Payments under a plan administered by an employer association, which guarantees annual income to eligible employees, are taxable wages. Rev. Rul. 73-22, 1973-1 C.B. 410; see also Rev. Rul. 61-68, 1961-1 C.B. 429. Such plans are not SUB plans, benefits from which may be excluded (see below), because payments are not linked to receipt of unemployment compensation. Similarly, payments to employees for "idle time," during which employees perform only part-time (or no) services for the employer, are taxable wages. Rev. Rul. 70-235, 1970-1 C.B. 193, amplified, Rev. Rul. 76-217, 1976-1 C.B. 310.

Reg. 31.3306(b)(8)-1 indicates certain "on-call" payments to employees over age 65 are not taxable for FUTA purposes. Since former IRC 3306(b)(8), to which this regulation related, was repealed, however, the regulation is obsolete.

Individual retirement accounts/SEPs

Employer payments to individual retirement accounts or SEPs are excluded from taxable wages for ITW purposes if, at the time of payment, it is reasonable to believe the employee will have a deduction under IRC 219(a), 220(a), or 408(k). Reg. 31.3401(a)(12)-1(d). Payments to IRAs are not excludable for FICA and FUTA purposes. See IRC 3121(a)(5)(C) (FICA); 3306(b)(5)(D) (FUTA).

Moving expenses

Employer payments of moving expenses are not taxable wages if, at the time of payment, it is reasonable to believe the employee will have a corresponding deduction under IRC 217. IRC 3121(a)(11), Reg. 31.3121(a)(11)-1 (FICA); IRC 3306(b)(9), Reg. 31.3306(b)(9)-1 (FUTA); IRC 3401(a)(15) (ITW); see also Rev. Rul. 70-482, 1970-2 C.B. 200.

Overtime

Payments to employees to participate in activities outside regular working hour are taxable wages. Rev. Rul. 68-596, 1968-2 C.B. 423.

Part-Time and Temporary

Wages paid to part-time or temporary employees are not excepted simply because of the part-time or temporary nature of the services.

Percentage compensation

Compensation based on a percentage of profits constitutes taxable wages. Rev. Rul. 72-119, 1972-1 C.B. 312.

Prizes or awards

The value of prizes or awards to employees is excluded from taxable wages if it is reasonable to believe, at the time of payment, the employee will have a corresponding exclusion under IRC 74(c). IRC 3121(a)(20) (FICA); IRC 3306(b)(16) (FUTA); IRC 3401(a)(19) (ITW).

Other prizes or awards are taxable wages, however. For example, Rev. Rul. 70-471, 1970-2 C.B. 199, held that cash awards to employees for suggestions on improving efficiency were taxable. Rev. Rul. 68-216, 1968-1 C.B. 143, reaches a similar conclusion for cash prizes to retail commission salesmen.

Retirement pay

FICA/FUTA: Excepted are any payment or series of payments to or on behalf of an employee or his/her dependents under an employer plan to provide generally for employees (or dependents), after termination of employment, on account of the employee's death, retirement for disability, or retirement at normal retirement age. IRC 3121(a)(13), Reg. 31.3121(a)(13)-1(a) (FICA); IRC 3306(b)(10), Reg. 31.3306(b)(10)-1(a) (FUTA). Payments which are not on account of these specified events (e.g., lump sum payment of unused vacation leave) are taxable, however.

ITW: Distributions from qualified pensions and retirement plans are generally taxable wages for ITW purposes, unless the recipient elects exemption from withholding on Form W-4P. However, no withholding is required for amounts taxable as annuities under IRC 72 or 403. Reg. 31.3401(a)-1(b)(1)(i).

Severance/dismissal pay

Payments due to an employee's "dismissal" are taxable wages for ITW purposes. Reg. 31.3401(a)-1(b)(4). Dismissal payments are similarly taxable for FICA and FUTA purposes. See H.R. Rep. No. 81-1300, 81st Cong., 2d Sess. (1950), reprinted in 1950-2 C.B. 255, 277 (FICA), 300 (FUTA).

Amounts paid by an employer to workers who are not re-employed after a strike is settled are dismissal payments, and taxable. Rev. Rul. 73-166, 1973-1 C.B. 411. Payments by an employer which terminates operations are similarly taxable. Rev. Rul. 71-408, 1971-2 C.B. 340.

Amounts paid pursuant to an employment contract for early termination of the contract are payments on account of dismissal, and taxable. Rev. Rul. 74-252, 1974-1 C.B. 287. Where

payments are made in consideration of the employee's agreeing to cancel an employment contract, however, they are not wages. See Rev. Rul. 58-301, 1958-1 C.B. 23; Rev. Rul. 55-520, 1955-2 C.B. 393.

Sick/disability pay

FICA/FUTA: Payments to an employee due to sickness or injury are generally taxable (except for worker's compensation, see below). However, payments made more than six months after the last calendar month in which the employee worked are excluded from taxable wages. IRC 3121(a)(4), Reg. 31.3121(a)(4)-1 (FICA); IRC 3306(b)(4), Reg. 31.3306(b)(4)-1 (FUTA).

ITW: Sick and disability pay are subject to withholding, since no exclusion exists.

Supplements to military pay

Payments to supplement military wages of employees temporarily absent from work while serving in a State National Guard are taxable wages. Rev. Rul. 68-238, 1968-1 C.B. 420. But see Rev. Rul. 69-136, 1969-1 C.B. 252 (payments to former employees on active military duty not taxable, because no employer-employee relationship exists).

Supplemental unemployment compensation (SUB) benefits

ITW: SUB benefits are taxable wages to the extent includable in gross income by the recipient. IRC 3402(o); Reg. 31.3401(a)-1(c)(13). These are amounts paid an employee, under a plan to which the employer is a party, due to involuntary separation from employment. Reg. 31.3401(a)-(c)(14).

FICA/FUTA: SUB benefits are not taxable only to the extent they supplement state unemployment compensation. Rev. Rul. 90-72, 1990-36 I.R.B. 12, revoking in part Rev. Rul. 77-347, 1977-2 C.B. 362, and amplifying Rev. Rul. 65-251, 1965-2 C.B. 395; see also Rev. Rul. 56-249, 1956-1 C.B. 488; Rev. Rul. 58-128, 1958-1 C.B. 89; Rev. Rul. 60-330, 1960-2 C.B. 46. Payments which do not supplement unemployment compensation are treated as severance or dismissal pay, discussed above. Rev. Rul. 90-72 provides for prospective application of its revocation of Rev. Rul. 77-347, relating to the link between SUB benefits and state unemployment compensation.

Survivor payments

Payments to a survivor or the estate of a deceased employee after the calendar year in which the employee died are not taxable wages. Reg. 31.3121(a)(14)-1 (FICA); IRC 3306(b)(15) (FUTA). Payments in the year of death are excluded only for ITW purposes.

Tips

FICA: Tips received in the course of employment are deemed to be remuneration for such employment. IRC 3121(q); Reg. 31.3121(q)-1. Tips are deemed to be paid when the employee

furnishes the employer the written statement required by IRC 6053(a) or, if no statement is furnished, when received. Non-cash tips, or cash tips of less than $20 per month, are not taxable wages, however. IRC 3121(12). In determining liability for the employer's FICA tax, tips are deemed paid only on the date the Service issues notice and demand for such taxes. Reg. 31.3121(q)-1.

The employer's responsibility for collecting the employee's FICA tax on tips is governed by Reg. 31.3102-3.

FUTA: Taxable wages include tips received in the course of otherwise taxable employment which are included in a written statement required by IRC 6053. IRC 3306(s).

ITW: Non-cash tips, and cash tips of less than $20 in a calendar month received in the course of employment, are not taxable wages. IRC 3401(a)(16), 3401(f); Reg. 31.3401(a)(16)-1, 31.3401(f)-1.

Vacation pay

Vacation pay or other allowance paid an employee during absence from work is taxable for all employment tax purposes. See Reg. 31.3121(a)-1(g) (FICA); Reg. 31.3306(a)-1(g) (FUTA); Reg. 31.3401(a)-1(b)(3) (ITW); see also Rev. Rul. 57-316, 1957-2 C.B. 626.

Welfare benefit plan (non-qualified)

Payments under a union health and welfare plan, funded by employer payments, are wages if the plan does not satisfy applicable requirements for exclusion. Rev. Rul. 70-51, 1970-1 C.B. 192; see also Rev. Rul. 57-33, 1957-1 C.B. 303.

Worker's compensation contributions

Employer contributions to a worker's compensation fund required by state law, either by paying insurance premiums or contributing to a self-insurance fund, are not wages because they are not remuneration for employment (but compensation for injuries). See Rev. Rul. 71-85, 1971-1 C.B. 280 (payments from self-insurance fund); Rev. Rul. 71-84, 1971-1 C.B. 281 (insurance premiums).

APPENDIX B

I. Meaning of "Employee" (vs. Independent Contractor)

Anesthetists

The treatment of anesthetists is discussed in two revenue rulings: Rev. Rul. 57-380, 1957-2 C.B. 634 (independent contractor), and Rev. Rul. 57-381, 1957-2 C.B. 636 (employee).

Athletic officials

Athletic officials, engaged through an association and paid by schools on a per game basis, were held not to be the association's employees in Rev. Rul. 67-119, 1967-1 C.B. 284. Rev. Rul. 57-119, 1957-1 C.B. 331, however, held that athletic officials selected, trained, and supervised by a college athletic association were the association's employees.

Brand inspectors

Individuals who performed services under the control of a 501(c)(5) stockmen's association, inspecting brands on cattle shipped or consigned from within the state to livestock markets, were held to be the association's employees in Rev. Rul. 72-533, 1972-2 C.B. 540. The same ruling held that inspectors who were authorized to act as such by the association, but did not work under its supervision and control, were independent contractors.

Bus drivers

The status of school bus drivers is discussed in two rulings: Rev. Rul. 56-172, 1956-1 C.B. 434 (employee); and Rev. Rul. 72-175, 1972-1 C.B. 316 (independent contractor).

Cemetery salespersons

An individual who sold lots and mausoleum spaces under a contract with a cemetery was held not to be an employee in Rev. Rul. 70-619, 1970-2 C.B. 228.

Corporate directors

Corporate directors (acting as such) are generally not its employees, under common law rules. See Reg. 31.3121(d)-1(b) ("[a] director of a corporation in his capacity as such is not an employee of the corporation"); Rev. Rul. 57-246, 1957-1 C.B. 338; Rev. Rul. 68-597, 1968-2 C.B. 463; see also Rev. Rul. 57-91, 1957-1 C.B. 326 (members of credit union supervisory committee are not employees of credit union, since it lacks right to control how they perform services).

Corporate officers

IRC 3121(d)(1) provides that officers of a corporation are employees for FICA purposes. Under IRC 3306(i), corporate officers are also employees for FUTA purposes. Officers are employees for ITW purposes only if classified as such under common law rules.

Day care workers

Individuals who perform day care services may be employees of an organization which serves as an intermediary between parents and workers, depending on particular facts. See Rev. Rul. 74-45, 1974-1 C.B. 289; cf. Rev. Rul. 77-279, 1977-2 C.B. 12 (individuals who performed day care services in their homes on behalf of a charitable organization, receiving $13/week/child to reimburse estimated out-of-pocket expenses, did not receive "wages").

Exam proctors

Proctors engaged by an association of employers to administer examinations were held to be employees of the association, in Rev. Rul. 72-270, 1972-1 C.B. 325.

Foster parents

Foster parents who have a profit motive in accepting children for placement from child placement agencies (see discussion of foster care payments in Appendix A) are generally not "employees" of the agency. Rev. Rul. 77-280, 1977-2 C.B. 14, modified on other grounds, Rev. Rul. 84-61, 1984-1 C.B. 39, held that because agencies looked to results of services, and did not control, or have the right to control, the foster parents, parents were independent contractors.

Golf association "handicappers"

An individual engaged by a golf association to supervise volunteer handicappers of member clubs and to assign each member desiring a rating an association handicap was held to be the association's employee in Rev. Rul. 56-131, 1956-1 C.B. 474.

Golf professionals

The status of golf professionals who perform services at clubs is addressed in two revenue rulings: Rev. Rul. 68-625, 1968-2 C.B. 464 (independent contractor); and Rev. Rul. 68-626, 1968-2 C.B. 466 (employee).

"Homemakers"

"Homemakers" placed by a non-profit agency to perform services in private homes were held to be the agency's employees in Rev. Rul. 55-95, 1955-1 C.B. 480. See also Rev. Rul. 73-268, 1973-1 C.B. 415 (individuals providing home care services to disabled persons were employees of government agency which placed them).

Instructors/teachers

The status of instructors and teachers has been the subject of several revenue rulings. Rev. Rul. 55-206, 1955-1 C.B. 485, held that a substitute teacher was an employee of the school board with respect to that service. Rev. Rul. 70-308, 1970-1 C.B. 199, held that part-time instructors engaged by a school offering courses for occupations in the airline industry were school employees. In Rev. Rul. 71-291, 1971-2 C.B. 343, instructors engaged by a board of education to conduct vocational education classes in a company's plant, under the control of the board of education, were held to be employees of the board. Driving instructors were found to be school employees where a school furnished training automobiles, trained them in its methods, and required them to give lessons under its name and conform to its standards. Rev. Rul. 68-598, 1968-2 C.B. 464.

Rev. Rul. 70-338, 1970-1 C.B. 200, concerned teachers at a music conservatory in two circumstances. The ruling held that teachers who instructed regular classes and received regular remuneration were school employees, but teachers who gave private lessons in return for a percentage of fees collected by the school were not.

Rev. Rul. 70-363, 1970-2 C.B. 207, held that law school instructors were employees of the school at which they taught. The ruling reasoned that in providing instruction, instructors were not engaged in an independent calling (the practice of law), but in the school's regular business.

Janitorial services

The status of persons performing janitorial services has been the subject of two revenue rulings. Rev. Rul. 68-461, 1968-2 C.B. 451, held such individuals to be employees of each person for whom services were provided. In Rev. Rul. 68-460, 1968-2 C.B. 449, however, individuals providing janitorial services were held to be employees of a company engaged in the business of providing janitorial services to property owners.

In recent congressional hearings, labor groups asserted that wide-spread employment tax abuses exist in the janitorial service industry.

Managers

Numerous rulings have considered the status of persons hired to manage property or business on behalf of the owner. In Rev. Rul. 55-328, 1955-1 C.B. 98, a cemetery sexton, hired to maintain a cemetery, was an independent contractor and not an employee of the cemetery. A restaurant manager, paid a percentage of the profits, was found not to be the owner's employee, in Rev. Rul. 55-18, 1955-1 C.B. 475. Individuals who managed a trailer park in exchange for a percentage of gross collections were held to be employees of the owners, in Rev. Rul. 62-124, 1962-2 C.B. 215. Similarly, individuals hired to manage a motel were employees, in Rev. Rul. 56-119, 1956-1 C.B. 469. Persons who managed apartments and hotels awaiting demolition for a low cost housing project were held to be employees of the property owner (a political subdivision), in Rev. Rul. 72-459, 1972-2 C.B. 538.

See also rulings discussed below under "Property Management."

Nurses/attendants

The status of nurses has been the subject of numerous rulings. (See also discussion of "student nurse" exemption in Part V of main text.) Rev. Rul. 61-196, 1961-2 C.B. 155, states basic principles. The ruling says registered nurses who perform private duty nursing services are ordinarily independent contractors, while nurses who integrate their services into the operation of hospitals, clinics, nursing homes, public health agencies, or physicians' offices are generally employees. The same rules apply, generally, to licensed practical nurses. The ruling cautions that--

> As in all situations where a determination as to the existence of either an employer-employee or independent contractor relationship is required, the complete factual data and all circumstances must be considered. The pertinent factors which must be considered are (a) the type and nature of the services performed; (b) the control exercised and by whom; (c) whether the individual is a licensed nurse; and (d) evidence establishing whether or not the services were performed in the conduct of an independent trade, business, or profession.

In the only published precedent applying Rev. Rul. 61-196 to nurses, Rev. Rul. 75-101, 1975-1 C.B. 318, held that a licensed practical nurse who worked through a nursing service agency was an employee of the agency.

In contrast to nurses, Rev. Rul. 61-196 says, nurses' aides, domestics, and other unlicensed individuals are generally, due to their lack of professional training, "subject to virtually complete direction and control in the performance of the services regardless of whether they work for a medical institution, physician, or in a private household ...." These workers, then, are generally employees of someone. See, e.g., Rev. Rul. 68-398, 1968-2 C.B. 439, modified on other grounds, Rev. Rul. 74-388, 1974-2 C.B. 325 (private attendant compensated by patient and selected from list provided by hospital was employee of patient).

Physicians

Reg. 31.3121(d)-1(c)(2) says physicians, "engaged in the pursuit of an independent trade, business, or profession, in which they offer their services to the public," are independent contractors. This does not mean physicians are never employees, however.

The following rulings address the status of physicians:

(1) Employees: Rev. Rul. 73-417, 1973-2 C.B. 333, superseding Rev. Rul. 261, 1953-2 C.B. 296 (pathologist engaged full-time to operate hospital pathology laboratory); Rev. Rul. 70-629, 1970-2 C.B. 228 ("associate" physicians who worked for professional services partnership); Rev. Rul. 61-178, 1961-2 C.B. 153, amplified, Rev. Rul. 66-274, 1966-2 C.B. 446 (physician with private practice who provided part-time service to company under supervision of company's head physician); Rev. Rul. 57-21, 1957-1 C.B. 317 (hospital resident who worked part-time at another organization as part of clinical training was employee of other organization with respect to service provided).

(2) Independent contractors: Rev. Rul. 66-274, 1966-2 C.B. 446 (pathologist who served as director of hospital pathology department, received percentage of income, compensated assistants, and could maintain private practice), amplifying Rev. Rul. 84, 1953-1 C.B. 404 (physician in private practice who provided part-time service to company as part of practice).

Researchers

In Rev. Rul. 57-127, 1957-1 C.B. 275, an individual received payment, through an institution with which she was associated, of government grant funds. She performed services under the grant free from direction and control by either the grantor or the institution. The ruling held that under the circumstances (not described in detail in the ruling), the individual acted as an independent contractor in performing services under the grant. In contrast, Rev. Rul. 55-583, 1955-2 C.B. 405, held that a professor, designated by a university to perform services under a grant it had received, was an employee of the university with respect to services performed under the grant. See also Rev. Rul. 71-292, 1971-2 C.B. 344 ("research associate" conducting research at the National Bureau of Standards on behalf of industrial association was employee of association, which paid his salary).

Retirees

A retired employee, retained by her employer to train a replacement, continued to be an employee with respect to post-retirement service. Rev. Rul. 55-695, 1955-2 C.B. 410.

Solicitors/canvassers

The status of persons who solicit sales, funds, or opinions from the public on behalf of an organization has been discussed in several published rulings. Rev. Rul. 74-333, 1974-2 C.B. 328, superseding Rev. Rul. 55-279, 1955-1 C.B. 486, held that an individual who solicited orders using a telephone, office, and supplies furnished by the company was an employee of the company; a second individual, who solicited from her home, without supervision and paying her own expenses, was an independent contractor. Telephone solicitors who worked at home soliciting students for a correspondence school, but were provided training, submitted daily reports, and received prospect lists and specified hours, were held to be employees of the school in Rev. Rul. 75-242, 1975-1 C.B. 321.

Door-to-door salesmen who worked under the direction of a crew manager and received company training were found to be employees of the company in Rev. Rul. 55-734, 1955-2 C.B. 413, while canvassers who determined their own working methods, hours, and territories were held to be independent contractors.

Rev. Rul. 75-243, 1975-1 C.B. 322, held that interviewers for a market research firm, who followed the firm's directions in conducting interviews, were reimbursed for certain expenses, were required to perform services personally, could not engage assistants, and filed daily reports, were employees of the firm. In contrast, in Rev. Rul. 65-188, 1965-2 C.B. 390, interviewers who were

not obligated to perform services personally and were not closely supervised with respect to how they conducted interviews, were independent contractors.

Union negotiators

Union members who perform services as the union's representatives in negotiations with employers are employees of the union. Payments by the union to its negotiators for such services are consequently taxable to the union. Rev. Rul. 68-539, 1968-2 C.B. 422. Non-members engaged to perform similar services were likewise held to be employees of a union in Rev. Rul. 74-510, 1974-2 C.B. 336.

Writers/editors

Several rulings have considered the classification of writers and editors. Rev. Rul. 72-176, 1972-1 C.B. 323, held that the editor of a social club's monthly magazine was the club's employee. Newspaper correspondents were considered in Rev. Rul. 60-148, 1960-1 C.B. 391 (employees), and Rev. Rul. 65-312, 1965-2 C.B. 394 (independent contractors). Rev. Rul. 56-660, 1956-2 C.B. 693, concerned a writer engaged by an organization to write a book on its history; the ruling determined the writer to be an employee of the organization.

II. Employer-Employee Relationship (Who Is the "Employer"?)

Janitorial service companies

See rulings under "Janitors," above, on employment by janitorial service companies.

Military duty

Payments supplementing military pay of former employees who are on active duty are not taxable, since no employer-employee relationship exists. Rev. Rul. 69-136, 1969-1 C.B. 252. Payments to employees temporarily absent to serve in a State National Guard are taxable, however. Rev. Rul. 68-238, 1968-1 C.B. 420.

Multiple employers

A clerical worker who performed services for two individuals on a regular basis was held to be the employee of each of them in Rev. Rul. 57-93, 1957-1 C.B. 328.

Physicians

"Associate" physicians engaged and paid by the director of a hospital pathology laboratory (an independent contractor) were held to be employees of the laboratory director, not the hospital, in Rev. Rul. 72-203, 1972-1 C.B. 324.

Physician's professional service corporation

A corporation which furnished secretaries, nurses, hygienists, and the like to professional firms such as doctors and dentists was held to be an employer in Rev. Rul. 75-41, 1975-1 C.B. 323, since it had the right to control and direct the workers' performance of services for subscribers.

Property management

Individuals who performed services in managing property for owners, who were engaged by a company which contracted with the owners to provide such services, were held to be employees of the property management company, in Rev. Rul. 70-266, 1970-1 C.B. 204. In contrast, where individuals were paid from separate funds supplied by the owner, Rev. Rul. 70-267, 1967-1 C.B. 205, concluded they were the owner's employees. The two rulings were distinguishable in that the management company in Rev. Rul. 70-267 acted as the agent of the owner in managing property (and hiring and compensating workers), while the company in Rev. Rul. 70-266 operated an independent business on its own account, with employees performing services for it and not the property owner.

Strike benefits

A union's payments to striking or "locked out" members are not taxable wages because no employer-employee relationship exists between the union and its members. See Rev. Rul. 68-424, 1968-2 C.B. 419; Rev. Rul. 58-139, 1958-1 C.B. 14, modified on other grounds, Rev. Rul. 61-136, 1961-2 C.B. 20 (in cases substantially like United States v. Kaiser, 363 U.S. 299 (1960), payments to striking members, based on personal need and similar factors, will be regarded as gifts and not gross income to recipient under IRC 61). Where, however, members must perform strike-related duties to receive benefits, payments are taxable. See Rev. Rul. 75-475, 1975-2 C.B. 406.

Trusts

Questions sometimes arise as to who employs individuals who perform services in managing trust property. The key ruling is Rev. Rul. 70-273, 1970-1 C.B. 206, which holds that individuals hired by a trust company, acting as trustee of a trust, who are paid from trust funds, are employees of the trust and not the trustee. The ruling cites Reg. 31.3121(d)-2(b), which provides that "[a] trust or estate, rather than the fiduciary acting for or on behalf of the trust or estate, is generally the employer."